IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-640

BERNARD GOLDBERG, REUBEN MITCHELL, JOSEPH SHANNON, ROBERT CHRISTEN, VICTOR CONDELLO, HARRISON J. GOLDIN, JAMES REGAN, individually and as Trustees of the Teachers' Retirement System of the City of New York and ISAIAH ROBINSON, individually as former Trustee of the Teachers' Retirement System,

Petitioners,

v.

ALFRED KIRSHNER,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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REASONS FOR DENYING THE WRIT

The Second Circuit has neither expanded nor embellished this Court's decision in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. (1975) by permitting Respondent, a beneficiary of a municipal pension fund, to proceed by

way of a derivative suit against Trustees of the fund under the anti-fraud provisions of the Federal Securities Laws [§17(a) of the Securities Act of 1933, 15 U.S.C. §77q, §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) and Rule 10 b-5 promulgated thereunder, 17 C.F.R. §240. 10 b-5] as well for breach of fiduciary duties under pendant state law.

The New York City Teachers Retirement System ("System") from which Respondent, a retired school teacher, receives a fixed annual allowance is funded by compulsory employer-employee contributions and income derived through the investment of those funds. Upon Respondent's retirement the total sum of his pension fund contributions plus accrued interest was immediately

transferred to the System's Annuity Reserve Fund. The total sum of the employer's compulsory contribution was simultaneously placed in the System's Pension Reserve Fund #1. These transactions <u>fully fund</u> Respondent's pension account, and, no further contributions are required during Respondent's lifetime.

These fixed funds are managed exclusively by the Trustees who are vested with the power to buy and sell securities. Three of the seven are active teachers. The retirees, some 25,000 in number, have no representation (4A)* and, as the Circuit Court held, the interests of the active and retired employees in the System's fund conflict. (4A-5A)

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*Reference denoted by letter "A" refers to Appellant's appendices.

The two fixed funds had been totally invested in high grade bonds when the City faced its "serious financial crises" (App.Br.p.7). The Trustees sold these high grade bonds at a loss of $204 million** and, commencing in 1975, purchased New York City Serial Bonds and MAC Bonds poorly rated and in many instances above the market price. At present 46% of the total assets of the two fixed funds from which respondent and other retirees derive their pension income is invested in New York City securities.

The City of New York is required to repay this $204 million loss and is doing so by making payments to the active teachers' Contingency Reserve

**$51 million is attributable to the Annuity Reserve Fund.

Fund with the result that Respondent's pension funds (Annuity Reserve Fund and Pension Reserve Fund #1) must still bear 100% of the loss. Under these circumstances the funds which Respondent and other retired teachers must rely upon for their pensions can no longer be described as "fully funded" as they are required to be. Thus, in the event that New York City becomes bankrupt, (unfortunately, a not remote possibility) the decline in the System's fixed assets and the negligible recovery value of the New York City and MAC Bonds, 46% of Respondent's funds fixed assets, make it mathmatically improbable that Respondent or other retirees would receive full pensions for their actuarily expectant lifetimes.

Respondent, in contributing to the pension, relied on the contractual representation that upon his retirement those sources from which his pension is paid would be <u>fully funded</u>. By wrongfully invading principal, the Trustees have jeopardized, if not wholly impaired, Respondent's ability to receive the fixed compensation to which he is entitled. For these reasons the Second Circuit stated:

> "We think the beneficiary of a pension trust, like a shareholder in a derivative suit, has standing to attack securities frauds perpetrated or threatened by the trustees of his fund.(14A)

It is also logical to conclude that the Second Circuit, under the facts alleged, found it unnecessary to determine whether Respondent's interest in this compulsory contributory pension plan was or was not a security.(26A)

The trust has been impaired as a result of securities violations committed by the Trustees in connection with the purchase and sale of securities. A trust beneficiary is left with little recourse except to sue derivatively to redress the wrongs occasioned by these violations.

<u>The Actionable Nondisclosure</u>

In effectuating the purchase of New York City and MAC Bonds it was incumbent that the Trustees obtain and IRS ruling that these purchases would not constitute "prohibited transactions within the meaning of §503(b) of the Internal Revenue Code of 1954, as amended...or otherwise adversely affect the tax status of the System's pension funds and §401(a) of Code." (7A) Respondent alleges that in seeking IRS approval the Trustees,

in five instances,***failed to disclose material facts, which, if disclosed, would have denied the Trustees the right to purchase the New York City securities.

Respondent alleged, and the Second Circuit agreed, (14A-15A) that the failure of the Trustees to make full disclosure of all material facts to IRS enabled them to purchase the New York City securities. Such nondisclosure, if proven, constitutes a violation of the Federal Securities Laws and entitles respondent, as a beneficiary of the funds to sue derivatively for such violations.(1)

***The five instances are forth on page 7A. By June 30, 1978 some 51% of the Systems assets were in New York City obligations.

1. WHILE RESPONDENT CONTENDS THAT HIS INTEREST IN THE PENSION PLAN IS A SECURITY WITHIN THE MEANING OF THE SECURITIES ACTS, THAT ISSUE, IN LIGHT OF THE CIRCUIT COURT'S DENIAL OF THE PETITION FOR REHEARING, NEED NOT BE CONSIDERED.

The Annuity Reserve Fund represents contributions made by Respondent and other retirees during the course of their employment with the Board of Education. Contributions to the plan were compulsory at a fixed minimum level, but most teachers voluntarily contributed more than the minimum requirement as an investment for the future. As a result of alleged violations of the Securities Laws by the Trustees, the corpus of this Annuity Reserve Fund has been depleted by almost $51 million.

Although the City's contribution to the "compensation package" was almost

double that of the majority of present retirees,* it cannot be claimed under the facts here alleged that a $51 million diminution should be overlooked regardless of whether Respondent's investment was based on an expectation of profits.

> " In every case the purchaser gave up some tangible and definable consideration in return for an interest that has substantially the characteristics of a security." [International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979)

As this Court stated in S.E.C. v. Howey, 328, U.S. 293 (1946)

> "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae".

The distinction between this action and Daniel is obvious. The consideration given by Respondent was not abstract

*Based upon the 1970 fiscal report.

in the sense that this Court treated Daniel's exchange of labor for pension benefits. Respondent's contribution was in part compulsory, in part voluntary and contributory. This constitutes an "investment contract" within the meaning and intent of the Securities Acts.

In reversing the District Court's dismissal of the complaint insofar as the Securities Acts claims are concerned, the Circuit Court held that a trust beneficiary "like the shareholder in a derivative suit, has standing to attack securities frauds perpetrated a threatened by the trustees of his fund".(14A) Clearly this is reflective of and in full accord with Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)

> "Third are shareholders, creditors and perhaps others related to an issuer who suffered loss in the

value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5. It has been held that shareholder members of the second and third of these classes may frequently be able to circumvent the Birnbaum limitation through bringing a derivative action on behalf of the corporate issuer if the latter is itself a purchaser or seller of securities. See, e.g., Schoenbaum v. Firstbrook, 405 F2d 215, 219 (CA2 1968), cert denied sub nom Manley v. Schoenbaum, 395 US 906, 23 L Ed 2d 219, 89 S Ct 1747 (1969)".

Since public retirement systems are excluded under ERISA's, detailed and complex regulations, protection against securities laws violations and breaches of fiduciary obligations by trustees empowered to manage such funds must be sought in the courts. Under Article V, Section 7 of the Constitution of the State of New York, membership in a public pension system is contractual in nature, and the benefits derived there-

from are to be neither diminished nor impaired. The source from which the benefits are derived must likewise be protected.

> " Close examination is therefore required of any radical change in means chosen to maintain the integrity and security of the sources from which the concededly protected benefits are to be paid". (Sgaglione v. Levitt, 37 N.Y. 2d 507, 512)

Here, the source has been diminished and impaired as a result of violations of securities laws by the fund's trustees in securing the right to purchase low grade New York City securities in exchange for a portfolio of high quality securities in not disclosing material facts which would have negated such action. This derivative suit by a beneficiary of the fund who sustained damage as a result of these Securities Laws violation is a proper means of obtaining redress for such wrongs.

2. THE TRUSTEES'CONDUCT IN FRAUDULENTLY OBTAINING A FAVORABLE RULING FROM IRS WHICH ENABLED THE FUND TO PURCHASE NEW YORK CITY AND MAC SECURITIES WAS DECEPTIVE AND VIOLATIVE OF THE SECURITIES LAWS.

In November, 1975 an agreement was reached wherein the Trustees agreed to acquire New York City securities over a 30 months period (6A). In December, 1975 the Trustees requested IRS to rule that these purchases were not prohibited transactions, and in seeking IRS approval the Trustees allegedly did not disclose:

> " (1) that the banks had sold City obligations in the previous year; (2) that City serial bonds were to be purchased at par when available at a discount; (3) the purchases would increase fund holdings of City obligations "to 32%"; (4) the Board intended to sell sound corporate bonds to raise cash to make these purchases; (5) the purchases were not for the exclusive benefit of beneficiaries". (7A)

The complaint alleges that the Trustees purchased the City and MAC securities with full knowledge of the City's serious financial condition. (2) The deliberate nondisclosure by the Purchaser-Trustees to IRS of these facts, known to the seller as well, enabled the Trustee, with the complicity of the seller, to obtain a favorable ruling and made the purchase of the securities a _fait accompli_.

Santa Fe Industries Inc. v. Green, 430 U.S. 462, (1977) holds that a breach of fiduciary duty without deception, misrepresentation or nondisclosure does not constitute a violations of the securities laws. _Santa Fe_, however, utilized the language previously employed by this Court in _Superintendent of Insurance v. Bankers Life & Cas. Co._ 404 U.S. 6, 12-13 (1977):

> " '§10(B) must be read flexibly not technically and restrictively' and that the statue provides a cause of action for any plaintiff who 'suffers an injury as a result of

> deceptive practices touching its sale (or purchase) of securities...' "(Santa Fe, supra at 475)

The Trustees' conduct as here alleged "touched" the purchase of securities. In O'Brien v. Continental Illinois National Bank and Trust,*593 F2d 54 (7th Cir. 1979) citing Santa Fe, at 477-478, the Court significantly stated,

> "...§10(b)'s fundamental purpose [is] requiring full and fair disclosure to participants in securities transactions of the information that would be useful to them in deciding whether to buy or sell securities". (at 60)

Here, although the investment decision of the Trustees was allegedly made with full knowledge of all material facts,

> "...disclosure to the directors, even the entire board, does not

* The decision of whether or not to terminate the Trust was not within the penumbra of 10(b).

> necessarily foreclose a §10(b) and Rule 10(b)-5 claim in favor of the corporation". Maldonado v. Flynn, 448 F Supp.1032, 1037 (S.D.N.Y. 1978)

See also Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), cert. denied sub nom. Manley v. Schoenbaum 395 U.S. 906 (1969)

3. A PRIVATE CAUSE OF ACTION IS RECOGNIZED UNDER §17A OF THE SECURITIES ACT OF 1933.

Appellant's reliance upon Touche Ross & Co. v. Redington ______U.S. ______, 99 S.Ct. 2479 (1979) and Cannon v. University of Chicago, ______U.S. ______, 99 S.Ct. 1946 (1979) is misplaced. In Redington this Court determined that a customer of a brokerage firm required to maintain records and file reports by §17(a) of the Securities Exchange Act of 1934, 15 USC §78q(a) did not have an implied cause of action for damages

under this section against accountants who audit such required reports which action was based upon misstatements allegedly contained in the reports. In deciding Redington this Court held:

> " Instead, our task is limited soley to determining whether Congress intended to create the private right of action asserted by SIPC and the Trustee. And as with any case involving the interpetation of a statute, our analysis must begin with the language of the statute itself". 61 L Ed 2d at 91.

The Court found that the statute construed did not create a private cause of action in favor of anyone. No class was identifiable to which private rights could be attributed nor did the statute proscribe any conduct as unlawful.

Respondent's action here attacked is brought under §17(a) of the Securities Act of 1933, (15 USC §77q) a statute

not discussed in Redington. This Court has heretofore elected to express no view as to whether this section provides a private party with an implied cause of action for damages. (Daniel, supra, 58 L. Ed. 2d at 815, note 9)

Respondent's derivative suit must stand as a viable claim under §17(a) of the 1933 Act. The Trustees of the fund are sued on behalf of the fund by a beneficiary to recover that portion of the corpus of the fund dissipated by the wrongful acts of the Trustees who are alleged to have violated applicable securities laws. Who but a beneficiary suing derivatively could seek such redress for these wrongs? See Person v. New York Post Corp., 427 F. Supp.1297 (S.D.N.Y. 1977), affd. without op. 573 F 2d 1294 (2d Cir. 1977).

In S.E.C. v. Texas Gulf Sulphur Co., 401 F. 2d 833, 867 (2d Cir.1968) the Court (Friendly, J.) observed:

> " Once it had been established however, that an aggrieved buyer has a private action under §10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under §17__ with the important proviso that fraud, as distinct from mere negligence, must be alleged".

See also Globus v. Law Research Service, Inc., 418 F. 2d 1276, 1283-1284 (2d Cir. 1969).

Based upon Respondent's status as a beneficiary of the subject pension fund, suing the trustees of the fund derivatively under §17(a) of the 1933 Act, the "four factors" described in Cort v. Ash, 422 US 66 (1975) and reiterated in Cannon v. University of Chicago, supra, have been satisfied.

> " We agree with the Seventh Circuit that the language of §17 is broad enough to imply a private right of action and that the beneficiaries of the Trust are persons claiming injury for the alleged fraud in purchase and sale of securities". (16A)

CONCLUSION

THE WRIT OF CERTIORARI SHOULD BE DENIED

November 8, 1978

Respectfully submitted,

ALFRED KIRSHNER
Respondent, pro se

FOOTNOTES

(1) Respondent's complaint, as the Circuit Court notes, contains other factual allegations of Securities Laws violations.

(2) Appellants do not raise the "scienter" issue in their Petition. The Circut Court found scienter to be sufficiently alleged in the complaint. (14A-15A)